Deregulation Will Not Eliminate Rural Banks

Interstate banking and branching are accelerating consolidation of the banking industry. Rural banks and branch offices that were already owned by large urban bank holding companies or banks are caught up in this process, but many rural banks will maintain their independent status. The degree to which rural lenders and their customers will be affected by other changes sweeping the industry is less clear.

While commercial banks today handle a declining share of the Nation's financial business, they remain critical players in rural economies. The U.S. banking industry has been evolving rapidly for at least two decades, but if anything the pace of change is accelerating. Geographic deregulation is dramatically changing the structure of the banking industry. Banks also continue to cope with interest rate and product deregulation. Additional factors, such as competition from other sources of financial services and technological innovations, further complicate the financial environment facing banks. Deregulation has largely resulted from attempts by State and Federal governments and financial regulators to help banks grow and retain their own financial health, so that they can compete effectively in an ever-changing world and promote growth in the overall economy. The consequences for both banks and the general economy are not always as intended, but there is no going back.

Interest Rate Deregulation for Consumers Is Well Established

Interest rate deregulation during the late 1970's permitted banks and thrifts to pay higher interest rates on a variety of deposit accounts. Although paying interest on checking accounts increased banks' cost of funds, the alternative was even worse—a continued flow of deposits out of banks and thrifts to newly popular alternatives, such as money market mutual funds. Unfortunately, this interest rate deregulation contributed to the savings and loan (S&L) crisis. S&L's made long-term mortgages that were funded by short-term consumer deposits. When market conditions forced them to pay higher interest rates on deposits, the mortgages became unprofitable. The S&L's were allowed to enter new lines of business in the hope of making up for the mortgage losses, but mismanagement, excessive risk taking, and fraud exacerbated the problems in too many cases.

Interest rate deregulation is not complete for business customers of banks. Current legislative proposals would allow interest to be paid on checking accounts held by business firms. Some financial institutions provide cash management sweep accounts as a mechanism to help businesses minimize lost interest by getting around restrictions on commercial checking accounts. But for many small businesses, the prohibition on interest-earning checking accounts represents a small hidden fee.

Large Banks Want Authority To Diversify into Other Types of Businesses

Banks offer many more financial products today than in past years, but often they must supply such products as limited brokerage services through affiliates of the bank holding company. Large banks in particular would like to go much further and gain the authority to directly provide comprehensive financial services, such as brokerage and insurance, and to take ownership positions in nonfinancial firms. Product deregulation is often couched in terms of repealing the depression era banking restrictions which separate commercial banking from insurance, investment banking, and commerce. Many people fear that banks might overextend credit to try to save troubled firms if the banks owned stock in those firms. They point to Japan's recent economic difficulties as an example of what could go wrong. Financial institutions in Japan failed to address loan repayment problems of their major industrial customers on a timely basis when the real estate used as collateral for many loans declined sharply in value.

Congress came closer than ever in 1998 to easing these restrictions, but has not yet succeeded because the regulators, banks, and insurance and brokerage firms disagree over the protections to build into the process. One stumbling block has been whether new financial services are to be provided through bank subsidiaries, or by extending the current system in which certain financial services deemed closely related to banking are sold by nonbank affiliates of the bank holding company (BHC). In the latter case, the Federal Reserve is responsible for supervising the new affiliates because it holds sway over all

BHC's, even if it does not directly regulate the associated bank(s). In the former case, the Department of Treasury gains an important role because its Office of the Comptroller of the Currency (OCC) regulates National banks, which would include most of the giant banks that are anxious to receive new financial powers.

The distinction may seem trivial and is often characterized by the media as a turf war between the Federal Reserve and the Department of Treasury. However, the huge cost associated with cleaning up the S&L disaster highlights the need for caution in removing existing restrictions. The financial world is rife with numerous examples that call for a conservative, incremental expansion of bank powers. As recently as September 1998, commercial banks, investment banks, and hedge funds announced billions of dollars in losses on their loans to Asia, Russia, and other emerging markets, and on potentially risky investments, such as foreign exchange rates and derivative contracts. New powers might bring additional opportunities for banks to make costly errors. On the other hand, the market share of commercial banks for financing large businesses has declined markedly, and U.S. banks must compete against foreign banks and other types of U.S. financial institutions that do not face the same restrictions. These facts argue in favor of at least liberalizing U.S. banking laws.

To a lesser extent, States also use financial deregulation as a development tool. Several States, such as Delaware and South Dakota, encourage BHC's to set up credit card bank affiliates. As the name suggests, credit card banks run the credit card operations for the other banks owned by the holding company. Back-room operations associated with processing credit card transactions and soliciting new accounts can create hundreds of local jobs. Delaware and South Dakota laws govern permissible loan conditions (interest rates, late fees) rather than the rules prevailing in the States where the other, more traditional banks are located. Credit card banks do not compete for local deposits or for other types of loans, so they are viewed as net job generators by their host State.

Large Banks Look for Acquisitions To Promote Efficiency and To Serve More Markets

Geographic deregulation is the most active ongoing form of financial regulation and is perhaps the most emotional for the overall population since many people have observed numerous name changes on their local bank offices. This would not matter if a new name was the only change, but it is often claimed that bank behavior changes as well following a change in bank ownership, especially when the new owner is perceived as a distant "outsider" with no interest in nor knowledge of the local economy. The raw national data for the reduction in numbers of banks and growth in interstate banking and interstate and intrastate branching is quite dramatic. But, when looking at the number of separate banking competitors, the situation appears much more stable at the local level.

A couple of arguments suggest that rural economies generally need not fear bank consolidation. Antitrust enforcement helps to ensure that the number of local competitors will not decline in many rural markets. In addition, banks generally are thought to be looking more favorably upon small-business lending for several reasons. Large banks need to identify new loan markets due to the intense competition that they face in their traditional markets. New technology and methods, such as the Internet and credit scoring models (an automated method of deciding whether loan applications should be accepted), allow banks that are so inclined to expand their markets far beyond those in which they have physical bank branches. This has long been true for credit cards and residential mortgage loans and is starting to be the case for small-business lending.

Large banks that fail to make local loans may be prodded to do so when some newly available data make local lending practices more visible. Revised regulations governing the Community Reinvestment Act (CRA) require large banks to annually report the number and amount of loans made to small businesses and to small farms starting in 1996. Large banks are defined as those with more than $250 million in assets, or belonging to BHC's with aggregate bank assets exceeding $1 billion. The geographic detail that accompanies the loan data makes it possible for the first time to measure some lending at the county level. Large banks that seem to make few loans in their rural markets will receive bad publicity. Their response may be similar to that observed due to mortgage loan application data collected from large urban mortgage lenders under the Home Mortgage Disclosure Act. Some banks found to reject black applicants much more often than white applicants have instituted programs to take a second, closer look before making final loan decisions.

Large Drop in Total Banks Overstates the Effect on the Number of Banks Serving Rural Communities

Any concerns expressed about the meaning of bank consolidation for the structure of U.S. financial markets are ultimately related to the effect on bank customers, rather than on the banking industry itself. Economic theory suggests that most industries perform better as the numbers of competitors increase. Rivals are induced to lower their prices and to find more efficient methods of producing their products so that the firms can earn profits even while lowering prices. In the current context, better performance by banks might take the form of lower interest rates charged on loans, higher rates paid for deposits, improved customer service, new types of financial services, and using technology to lower the cost of producing financial services. While the total number of banks is dropping, the market for most financial services is local or regional, rather than national. The number of different banks serving a town or county is what really matters. Urban counties averaged 11.02 banking firms with at least one office in the county at the end of 1990, declining slightly to 10.90 banking firms by the end of 1997. But the average number of banking firms serving rural counties actually increased from 4.05 to 4.33 between 1990 and 1997.

The number of insured commercial banks declined from well over 14,000 during the early 1980's to 9,128 by the end of 1997, of which 5,108 had rural headquarters. While many banks failed during this period, the major cause for the decline in bank numbers was bank mergers, many of them between banks owned by the same holding company, with one bank and its branches becoming branches of the other bank. If all multibank holding companies were to consolidate their affiliates to a single bank per holding company, the number of banks would drop to 7,029, including 4,067 rural-based banks. This would still leave America with many more banks and other types of financial institutions than are typically found elsewhere in the world. Further, the number of banking firms serving any particular rural county would generally not be reduced by this process. The effects of consolidation primarily show up in statistics for larger areas: Metropolitan Statistical Areas, States, and the Nation.

New banks are often created in the wake of bank mergers. Some local investors and bankers see mergers as opportunities to capture customers of banks that are no longer locally owned. Trade publications present examples of bankers who leave their acquired banks to start new banks that emphasize local ownership and local decisionmaking. The number of new banks has been growing in recent years and many of them may do well. But this will not change the underlying consolidation trends since the most successful, fastest growing new banks become tempting targets as future acquisitions by other banks that wish to enter or expand in those markets.

Some BHC's are said to favor an approach in which their affiliated banks retain a relatively strong degree of local autonomy. The idea is to profitably use their employees' knowledge concerning local borrowers and local economic conditions. However, recent data on numbers of interstate branches provide convincing evidence that many banks either prefer centralized control over all banking offices or have decided that the cost savings associated with a reduction in separate bank charters outweigh any benefit of maintaining nominally independent bank affiliates.

Corporate Reorganizations Have Increased the Number of Interstate Branches

As recently as 1989, there was only a handful of interstate branches. Interstate banking was common by then in the form of multibank holding companies that owned banks in more than one State. But the 11 interstate branches represented an exception at that time. However, the situation changed rapidly. Additional exceptions resulted in 5,680 interstate branches in existence on May 31, 1997, the day prior to when a provision of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 first officially permitted interstate branching in most States. Growth in interstate branching has been explosive since then, with 9,681 as of June 30, 1997, and 13,820 interstate branches by June 15, 1998. Does this sort of rapid change imply a new way of life for bank customers? And how could so many interstate branches exist before the Riegle Act became effective?

At a simple level, interstate branching affects many rural areas because 2,314 of the 13,280 interstate branches are in rural counties (table 1). But rural customers often may perceive few differences beyond a name change if a corporate reorganization results in the local bank branch being added to the list of interstate branches. Ownership of the bank office does not really change when a bank holding company combines banks and their branches that it controls in several States under a single bank charter, with offices in the other States now counting as interstate branches. More fundamental changes occur if the holding company takes this opportunity to apply uniform procedures and products to all bank offices.

States vary considerably with respect to the numbers of interstate branches in the State. Thanks largely to NationsBank and First Union, North Carolina banks own an amazing 5,693 of the 13,820 interstate branches (table 1). Banks in Alabama, California, Minnesota, and Ohio also control large numbers of bank branches in other States. Florida, Georgia, New York, Oregon, Pennsylvania, Virginia, and Washington have the most bank branches owned by outside banks (table 2). The large Texas banks are generally under outside control but most have been prevented by Texas law from being merged into banks in other States. Montana does not participate on either side of interstate branching.

NationsBank, recently renamed Bank of America after a merger, is a leading example of how banks expanded to new markets across the country and consolidated their operations. It has evolved over time in response to changes in legislation, regulation, and financial market structure and competition. Liberal statewide branching regulations in North

Table 1

Interstate bank branches, by bank headquarters State location, selected States, June 15, 1998

The largest number of interstate bank branches are headquartered in North Carolina

State	Metro	Nonmetro	Total
		Number	
North Carolina	5,041	652	5,693
Ohio	1,119	384	1,503
California	1,154	251	1,405
Alabama	861	138	999
Minnesota	656	267	923
Pennsylvania	436	5	441
Missouri	151	72	223
New York	231	2	233
Virginia	216	11	227
Mississippi	70	18	88
Idaho	4	10	14
Florida	0	13	13
Oregon	6	4	10
Washington	0	4	4
Total	11,506	2,314	13,820

Note: Shows number of branches located in metro and nonmetro counties in other States that belong to banks headquartered in each State.

Source: Calculated by ERS from the Federal Reserve Board's NIC database.

Table 2

Location of interstate bank branches, selcted States, June 15, 1998

Florida and Washington State have the largest number of branches owned by out-of-State banks

State	Metro	Nonmetro	Total
		Number	
Florida	1,542	89	1,631
Washington	833	172	1,005
Georgia	699	145	844
New York	703	119	822
Virginia	662	140	802
Pennsylvania	587	60	647
Oregon	414	126	540
Missouri	273	95	368
Idaho	88	224	312
Mississippi	58	111	169
California	87	24	111
Ohio	75	6	81
North Carolina	38	10	48
Alabama	42	1	43
Total	11,506	2,314	13,820

Note: Includes insured commercial bank branches that belong to banks headquartered outside the State. Metro or nonmetro refer to the branch's location.

Source: Calculated by ERS from the Federal Reserve Board's NIC database.

Carolina facilitated the initial growth of NationsBank and several of its local competitors. They purchased other North Carolina banks and converted them into branch offices. During the 1980's, North Carolina and several neighboring States formed a regional compact to permit bank holding companies based in one of those States to acquire banks and bank holding companies in the other States. NationsBank also acquired financial institutions in Texas. Though Texas was not party to the Southeast interstate banking compact, Federal banking regulators made an exception as part of their effort to cope with numerous bank failures at that time. The holding company for NationsBank was later able to acquire banks in many additional States after those States authorized interstate banking transactions. The Riegle-Neal Act made it possible for NationsBank (or any other bank holding company) to acquire banks in any State as of September 29, 1995.

Besides moving into new markets, NationsBank has been quite aggressive at consolidating its bank affiliates both within a given State and across States. For example, Texas and some other States previously did not permit banks to have branches. Expansion within these States was accomplished by holding company acquisitions, with each bank remaining legally separate. As host States for banks controlled by NationsBank liberalized their own branching restrictions, bank affiliates were converted to branches of one or more lead banks within the State. At one point, Texas allowed county branching, before moving to statewide branching more recently. NationsBank could then merge its Texas affiliates into a single Texas bank with many branches. A loophole known as the 30-mile exception was used to combine operations in certain neighboring States. The Riegle-Neal Act allowed wide-scale interstate branching beginning in mid-1997. Though Texas and Montana chose to opt out of interstate branching, NationsBank again used the 30-mile exception in May 1998, this time to circumvent the Texas opt-out. Texas offices became branches of a New Mexico affiliate, and then both Texas and New Mexico banking offices became branches of the NationsBank lead bank in North Carolina.

Do Urban-Based Banks Make Enough Small Business Loans in Rural Areas?

While this article primarily describes how geographic deregulation is changing the structure of the banking industry, interest in this topic ultimately derives from any effect of bank consolidation on the ability of rural people and businesses to obtain a comprehensive range of financial services at a reasonable cost. Adequate credit for small businesses from banks and other financial institutions is considered critical to the health of rural communities. Large banks are not going to displace community banks any time soon, but they do have a strong and growing presence in many rural markets. Is the extent of lending by urban banks to rural businesses sufficient? It is outside the scope of this paper to really answer this question. But data required by the Community Reinvestment Act can be analyzed to determine the amount of rural business and farm lending by large banks during 1996. Unfortunately, most independent rural banks are too small to file these data, and we cannot accurately compare relative lending by local banks and local offices of outside banks.

Reporting lenders made 2,331,209 small business loans worth $142.7 billion during 1996 (table 3). Urban lenders issued 306,552 of these loans to rural borrowers in the amount of almost $15.1 billion. Rural lenders made an additional 153,058 loans worth about $8.0 billion to rural borrowers.

However, placing these results in perspective is not easy. Urban lenders are important players in rural markets; they made twice as many rural loans as did the rural lenders. That the

Table 3

Loans made to small businesses and to small farms during 1996, by metro or nonmetro location of lender and borrower

Metro lenders made twice as many nonmetro small business loans as did the included nonmetro lenders, but the numbers of farm loans were much closer

Type of loan and location of lender	Unit	Location of borrower: Metro	Location of borrower: Nonmetro
Loans to small businesses:			
Metro lenders—			
Loans	Number	1,844,871	306,552
Amount	Billion dollars	117.3	15.1
Nonmetro lenders—			
Loans	Number	26,728	153,058
Amount	Billion dollars	2.3	8.0
Loans to small farms:			
Metro lenders—			
Loans	Number	50,407	82,615
Amount	Billion dollars	3.1	4.2
Nonmetro lenders—			
Loans	Number	5,078	76,249
Amount	Billion dollars	.2	2.7

Note: Loans made by lenders headquartered in Puerto Rico or made to borrowers in Puerto Rico were excluded. Includes data from 1,869 lenders that originated at least one business loan and 1,137 lenders that reported making at least one farm loan on this database.

Source: Calculated by ERS from Community Reinvestment Act data collected by the Federal Financial Institutions Examination Council for loans originated during 1996 by commercial banks, savings and loan associations, State savings banks, and Federal savings banks that had assets over $250 million or belonged to holding companies with aggregate assets above $1 billion. These lenders must report each business loan made during the year of less than $1 million and farm loans below $500,000.

extent of rural lending by urban lenders pales in comparison to their urban lending does not necessarily signal a problem since urban markets are much larger and many urban lenders do not even have rural branches. On the other hand, these data exclude thousands of rural banks that either are independent or belong to small BHC's. The rural efforts of urban lenders might look weaker if we had more complete data. Lacking this, future analysis could try to compare reported loans to the amount of rural deposits held by these lenders.

Looking at the CRA farm loan data in a similar manner is interesting. One can argue that separating farm loans and business loans is artificial, since agriculture is just a type of business that happens to be very important in rural areas. A common argument against bank consolidation is that large urban banking firms may reject some rural loan applications because the banks lack understanding of local conditions. Supporters of bank mergers argue that large banks may make more loans because they are familiar with types of businesses that are new to rural communities. The farm data can support either assertion.

Urban lenders made more farm loans (82,615) than did the rural lenders (76,249), but not by much. Urban lenders maintained a wider margin in the amount of rural farm loans, with initial face values of $4.2 billion versus $2.7 billion for rural lenders. Does its relatively smaller market share for farm loans and larger average loan size represent a conscious effort by urban banks to avoid lending to local farmers? Or were urban banks filling a gap by concentrating on loans for purposes other than farming that were not being handled by their rural competitors?

Many of the rural banks that reported CRA loan data hold less than $250 million in assets and therefore filed the reports only because they belong to large bank holding companies. Thus, the above results probably understate the amount of rural lending by urban-based banking firms. Of the 1,869 reporting banks that made small business loans during the year, 496 were small. The latter included 272 of the 468 banks with rural headquarters.

Conclusion

Most rural banking offices have not disappeared and will not disappear, unless technology advances to the point where physical branches are no longer required to facilitate financial services. In terms of the ongoing process of bank consolidation, Federal antitrust guidelines generally prohibit most mergers of banks in small rural communities. For example, regulators usually refuse applications by two banks to merge in a town served by only three financial institutions, due to the presumed reduction in competition. On the other hand, regulators would not care if all three banks were acquired by different outside banking firms, provided these firms had adequate records of serving customers in the various communities containing bank offices of those firms. That is the most debatable issue. Many local advocates are deeply skeptical as to whether outside firms maintain the previous level of community service after taking over local banks. *[Daniel Milkove, 202-694-5357, dmilkove@econ.ag.gov]*